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Issue Article

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TITLE: THEORY OF EXCHANGE IN ISLAMIC FINANCE

***Abstract**: This paper explores the concept and theory of exchange from classical, modern, and Islamic perspectives. It begins by examining the notion of exchange in social sciences and economics, comparing social exchange theory with economic exchange theory in terms of tangibility and value. It reviews the contributions of key thinkers such as Aristotle, Marx, and Al-Ghazali, discussing how each conceptualized value and the role of money in economic transactions. The paper particularly highlights Islamic perspectives, showing how Islamic scholars such as Al-Ghazali addressed exchange, money, interest, and trade ethics in accordance with Shari'ah. Various forms of exchange, including spot and deferred transactions, are analyzed in the context of Islamic finance. The paper concludes that exchange is the core of economic activity and, when governed by ethical and legal principles, contributes to equitable value creation and resource distribution in society.*

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Introduction

The word "exchange" has been widely used for centuries in many areas including art, social sciences, technology and etc. The classical definition of exchange is an act where one party gives one thing and receives another in return (Peterson, 2017). Exchange is also central to the study of marketing as a discipline. The definitions of the marketing process have been focused on exchange between parties (Lambe et. al., 2008).

Exchange theory is a term that includes various theoretical traditions that focus on exchange relationship and interactions. There is little research has been conducted in this area and according to the findings of those research this respective theory can address the effects of structure of exchange, process of exchange as well as outcomes of exchange. Time by time this theory has been advanced and attention has been given to emotional and behavioral outcomes of exchange which may include commitment, trust and collective behavior (Peterson, 2017). The theory of exchange has widely been used in social sciences. Thus, Social Exchange theory (SET) explains the factors influencing interaction among the human beings. The theory assumes that behavior of individuals' in the marketplaces is motivated by a desire to maximize profits while minimizing losses. In addition, SET explains the outcome of individuals to different social interactions by examining the exchange of resources during the social interactions. Thus, the resources could be in the form of material goods and services or an exchange of social value (Kim, 2016).

For the purpose of this paper the author will discuss the exchange in social sciences, specifically how exchange is used in the field of economics and finance, and what it means by classical and modern economists. According to Investopedia, exchange is "a marketplace in which securities, derivatives and other financial instruments are traded".

Literature Review

The principles which guide men in their economic activity are the things which guide them to explore the useful things surrounding them in nature and to subject them to their command, and make them to be concerned about the advancement of their economic positions. They are the efforts to satisfy their needs as completely as possible, which lead them to search the most diligent relationship and exploit it for the sake of satisfying their needs. The effort which is spent to satisfy the needs as completely as possible is the cause of all phenomena of economic life which is called as *exchange*. The word exchange in economics also includes sale and purchase and all partial transfers of economic goods like rental, lending, etc. for compensation (Menger, 2007).

When we say Theory of Exchange, the first thing which comes to people's mind is the Social Exchange as it is also widely used in the societies. Therefore, it is important to differentiate those two theories from each other. Theory of Exchange in Economics is different from the Social Exchange Theory in terms of firstly tangibility. The former one involves quantifiable material goods while the latter is based on intangible goods which cannot be quantified. In order for an exchange to produce durable and rational outcome, the goods involved in exchange must have an underlying value (Murdvee, 2009). According to Blau (1964) those who are involved in exchange are committed to seeking the exchange if in return they receive goods that have been estimated value to the exchange of goods they have given. Furthermore, economic exchange mainly takes place in the market where the allocation of resources implies to principles of maximization of profit (Murdvee, 2009). In economics, exchange always comes with the value. In the following paragraph the Exchange theory of Value will shortly be discussed.

Methods

This study uses both conceptual and comparative methods. It looks at the definitions and uses of exchange theory as explained by classical economists and Islamic scholars through a thorough review of the literature. The paper combines information from history, philosophy, and religion to show how different cultures understand the ideas of value and exchange. The main focus of the approach is on qualitative and interpretive data.

Analysis

Theory of Value by Classical Economists vs. Islamic Scholars

Most of the ancient scholars and the Greeks had no formation of "rational laws governing the phenomena of the distribution of wealth". Rather they were more concerned on the duties of men and actions involved to have noble lives, issues related to rights and wrongs and justice. They did not study the ultimate relationship of actions. Due to the result of such attitude, the pure concept of value as a quality belonging to the thing itself was somehow not questioned. It was generally accepted that the price has to relate or match to this quality which often this matching did not happen. Plato for instance, reflected by stating that, "when a man undertakes a work, the law gives him the same advice which was given to the seller, that he should not attempt to raise the price, but simply ask the value; this law enjoins also on the contractor; for the craftsman assuredly knows the value of his work" (Laws, book xi, ch. 92I). Aristotle had the same view as Plato but he understood the influence of demand upon value more clearly than Plato. His explanation of value gave a big important to the philosophers of the later age. For him exchange is "due to the needs of men, and arises from the circumstances that some have too little, and others too much". He added that for the objects to be exchanged they must be equal, and the resulting equation is an expression of value. However, he said the value has its basis in utility. He also said that whatever individuals own there are two uses of them; both uses belong to the same thing in a different way. For example, a dress is used to wear, and is used for exchange; here both are the uses of dress. In this statement, Aristotle explained the value in use vs. value in exchange, and gave a basis for such distinction. When one exchange the dress for money or food to the one who needs dress then he/she use the dress to wear; but it is not the primary use as the dress is not made to be an object of the barter. This is only due to its primary use that an object (dress) can be used in this secondary manner (Sewall, 2014).

Aristotle's View on Exchange Value

Aristotle's view on economic issues is mainly related to Ethics and Politics. He was more concerned with the justice in the exchange of goods and services, and this gives rise to an effort at a theory of exchange value. In addition, he was very concerned on creating justice in lending which leads to observations on interest taking and money. For Aristotle, the state constitutes both labor and resource division to build a household. According to him if the economic life of the society is to afford them enough subsistence then there must be an exchange of goods and services between households. If the process of exchange is to avoid being a source of social disruption then it must be in line with rules of reciprocal justice. Another important point needs to be mentioned here is the money and interest. Money, for Aristotle, is a medium of exchange which comes as a unit of account and as a means of deferring consumption (Ethics 1133a-b). He stated that money "becomes in a sense an intermediate as it measures all things including excess and deficit". In his statement the role of money is being treated in a way today's economists perceive the money in international trade instead of domestic market exchange. Since the money was considered as a medium of exchange by Aristotle, he gave a strong argument against taking interest on monetary loams. He reasoned his statement as:

"The trade of the petty usurer is hated most and with most reason: it makes a profit from currency itself, instead of making it from the process which currency was meant to serve. Currency came into existence merely as a means of exchange; usury tries to make it increase" (Politics, 1258b).

He supported saying that lending at interest contains misconception of the role of money as an institution and therefore it has to be criticized. Among the Greek philosophers, he was the only thinker who related his judgment of usury to a theory of money. Thus, for him money has a state backed acceptance to execute of certain types of social functions (Gordon, n/a).

Aristotle's main objection to usury was based on his view of the "nature of money", based on the fact that nature of money is not subject to physical growth. For him, money had a nominal value and characteristic of demand for mutual services and exchange in barter system (Taeusch, 2014).

Marx's Theory of Value

Marx's theory of value was written during 1857-67 and published in the first Volume of Capital which includes a new theoretical proposition theory of value to the Classical Political Economy. According to him products of labor becomes values as they are produced within the scope of the capital relation. His opinion on value is different from Ricardo's concept of value as the latter sees the value as "labor expended" which contains a complex conjoining of the specifically capitalist features of the labor process with the corresponding forms of appearance of the products of labor, making it possible in this way for the capital relation to be deciphered Heinrich 1999, Milios, Dimoulis and Economakis 2002). Instead, Marx states that the value discloses itself in the form of money, where money is the indication *par excellence* of (value and thus of) capital. He claimed that value is an expression of relations entirely characteristic of the capitalist mode of production. The value records the affiliation of exchange between each and all other commodities and states the outcome of the specifically capitalist homogenization of the labor process in the Capitalist Mode of Production (CMP), as summarized in the concept of abstract labor (Milios, Dimoulis and Economakis 2002: 17-23). To him, value is determined by abstract labor which not a practical magnitude that could be measured by using a stopwatch. It is an "abstraction" contained (i.e. obtaining tangible existence) in the exchange process. In addition, Marx developed his theory of value out of an analysis of commodity circulation. In order being able to interpret the appearance of value as money he introduced the "simple form of value" framework in which a quantity of a commodity is exchanged for a (different) quantity of another commodity. This process is considered as barter by classical economists. Later those economists believed that all transactions hold in market can be reduced to simple act of barter which are facilitated by money. In short, according to Marx a simple form of value measures only the exchange value of commodity A in units of the equivalent B (Milios, 2015).

Marx' Labor Theory of Value

His introduction to Labor theory starts with differentiating use-value from exchange-value. He defined use-value as a product or service created to satisfy someone's needs and wants regardless those goods are useful or not; he measured it qualitatively. For him, exchange value is generated to be exchanged for other use-values, and basically defined quantitatively. In this theory, Marx states that a labor is the one who creates the value of any commodity. And, he states that labor power is the source of surplus. The theory focuses on 2 different types of economy. The first one is the economy in which no more is produced than is used up in its production of goods, called simple commodity production. This is also called subsistence economy, where the value of a commodity is equal to the amount of total commodity used in producing it. While in the second type of economy the production of commodities is also the production of surplus. This is because compared to the consumption the production of goods is higher and it creates surplus. Thus, after replacing costs of all resources used for production there is a surplus of valuable goods, therefore the production process is a process of adding value.

In short, his labor theory serves two main purposes: the first one is to point out the fact that the worker sells labor-power to the capitalists, who owns the product of that labor-power; the second purpose is to consider the antagonism between capitalist and the worker due to the struggles resulted from long working hours/days (King & Riptein, 1987).

Al-Ghazali's view on Exchange Value

Al-Ghazali was a Muslim philosopher, theologian, jurist, mystic of Persian descent, and an expert in the economics, specifically on Ethics of Islamic Finance. During his period, Islamic economics had grown widely and was characterized by the growth of Muslim empire. His economic views mainly focused on micro-economic analysis and functions of money. He mentioned a lot on money, its functions and evolution of using it. He also stated the issue of prohibition of riba and its negative impacts on the economy of the society.

Al-Ghazali used the term blacksmith, carpenter, and farmers to exchange ownership in order to satisfy the needs of individuals. By this way they form a place called "market" to exchange the different needs between each other. Later he stated that the main objective behind market is to raise capital and profits. Furthermore, Adam Smith (1723-1790), a classical economist who lived 700 years after him gave almost the same view on the process of formation of market (the exchange) by using different terms like butcher,

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brewers, and a baker (Irijanto et.al. n/a). The philosopher in his Ihya Ulum ad-Din book defined the *money* as a good or object that serves as a means to get goods. He likened the money as a mirror that does not have its own color but can reflect all types of colors. In addition, he said that money has no intrinsic value, specifically no intrinsic value of a currency that's shown by its real existence; and its fully related to the issues surrounding the demand for money, usury and selling currencies.

Barter System and the Evolution and Functions of Money

Money is one of the most crucial inventions as a means to facilitate exchange in economic transactions. Al-Ghazali offered a powerful discourse to the conditions which lead to the evolution of money and its functions. In his discussion, he included the barter system and its difficulties, the role of money, its harmful effects, currency debasement; abuse the function of money and misuse of money. According to Al-Ghazali:

"Creation of dirhams and dinars (i.e., gold and silver coins) is one of the bounties of Allah. The entire world of economic activities is based on transactions with these two kinds of money. They are two metals, with no benefits in themselves. However, people need them, in order to exchange them for different things -- food, clothing, and other goods. Sometimes a person needs what he does not own and he owns what he does not need. For example, a person has saffron but needs a camel for transportation and one who owns a camel does not presently need that camel but he wants saffron. Thus, there is the necessity for a transaction in exchange. However, there must be a measure of the two objects in exchange, for the camel-owner cannot give the whole camel for a quantity of saffron. There is no similarity between saffron and camel so that equal amount of that weight and form can be given. Such barter transactions would be very difficult. Various forms and types of goods such as these need a medium which could rule justly and determine their value or worth according to their place in exchange. When their place and grades are ascertained, it is then possible to distinguish which one is equal to each other and which is not. Thus, Almighty Allah created dinars and dirhams as two rulers and medium of exchange for all goods and the value of goods is measured through them. So it is said a camel is, say, equal to 100 dinars and this much quantity of saffron is worth 100 dinars. Since each of them is equal to a given amount, the two quantities are equal to each other. This equality of worth or value becomes conveniently possible through dinars only because those dirhams and dinars are not needed for themselves. Allah created dirhams and dinars to change hands (to circulate) and to establish rules between exchanging of goods with justice and buying goods which have usefulness. A thing (such as money) can be exactly linked to other things if it has no particular special form or feature of its own -- for example, a mirror which has no color but can reflect all colors. Same is the case with money – it has no purpose of its own, but it serves as medium for the purpose of exchange goods."

From the above quotation, it can be stated that Al-Ghazali understood the difficulties in barter system and manners in which the invention of money overcomes those problems. He clearly stated that problem that will exist without a common denominator which are a) shortage in value measurement; b) invisibility of goods meant to be exchanged; c) the issue in establishing the double-coincidence of wants without the use of money. Voluntary exchange is highly recognized by AL-Ghazali as people do not necessarily produce and possess everything they want. But in order to ease the exchange in the market place, the value of things must be clearly known and understood by parties. Thus, according to him this is where values expressed in money become superior to a barter system. Though some products can directly be exchanged for other, but there are some goods which have different features and usage in which the value cannot be easily expressed in terms of another. Therefore, in such cases money becomes a common denominator (Ghazanfar & Islahi, 1997). Thus Al-Ghazali concluded that charging interest deflects money from its function as a medium of exchange and a measure of value.

To conclude, AL-Ghazali gave an important view on economic thought. He gave a brief and clear discussion on the functions and problems of a barter economy, evolution of money and a monetary exchange. He understood the issues related to invisibility and double coincidence of wants in barter system and how the invention of money solves the exchange problem issues. He identified the functions of money in a way that we can find in most of the current text books. He said that Allah Almighty created money to serve as a measure of value and meant to be a neutral agent of commerce, but practicing interest has made it neurotic master (Islahi, 2001).

Theory of Exchange from Islamic perspective

The central part of economy is exchange which coordinates consumption and production. It is considered a core discipline of business activities and main part of the market economy. The term exchange in Islamic literature is usually translated as a trade or sale; however, it has broader meaning and applications compared to what thought of it. It covers economic activities that capture the connotations; replacement, substitute bay' (sale), trade, preference or choice. In Islamic law (fiqh) context, when two types of benefits/utilities are exchanged it is called as trade. In its tangible form, it is the transfer of a good/service in return for another or a commodity in exchange for money. Qur'an provides us the comprehensive form of exchange and gave us a choice or preference mentioning that "these are they who have purchased error in exchange for guidance their trade has brought them no profit" (Qur'an, 2:16). The concept of exchange is recognized as a part of human interaction, and it is discovered that exchange is the purest and widely developed kind of interaction which forms human life in obtaining substance and content. It is also important to say that islam puts a great importance and encourage to be involved in exchange as it is the major source of generating real income. Shari'ah encourages people to be developed and to avail themselves of the bounties of Allah (Zarqa, 1992). Shari'ah put governing principles of exchange for two main purposes, which are a) for increasing the gains from exchange; and b) for minimizing the expenses and unnecessary possible difficulties that exchange may face (Zarqa, Ibid).

Forms of Exchange and Incremental Value in Islamic financial transactions

According to the Islamic scholars, profit is the result of commercial activities or increase by involving into trade. Literal definition of exchange is the transfer of one good in return for another. It can be in the form of barter or goods exchanged for money or even money for money like currency transfer. In today's economy there are many forms of transactions for exchange depending on the nature of goods, contractual agreements and needs of the parties. They are: a) exchange of one good for a particular good; b) exchange of goods/services for money; c) exchange of money for money. Studies of Islamic finance categorize transactions based on the time element attached with transactions. Trade is divided into two main categories, which are namely spot/current and deferred transactions. The spot transactions involve immediate exchange of give and take goods with no delay; it is called Tijarah hadirah in Qur'anic term. Spot transactions may not require for reducing them in writing. It can be proved by the following verses of holy Qur'an, "…but if it is a transaction which ye carry on the spot among yourselves, there is no blame if ye reduce it not to writing" (Qur'an, 2:282). The deferred transactions include three main categories, a) price deferred sale; b) object deferred sale; c) object and price deferred sale. The first two categories involve delaying in delivery of either consideration and they mostly referred to bay' al-salam and bay al-mu'ajjal respectively. The third one is exceptional form of selling absent object for delayed payment. The deferred exchange as it falls under the term al-bay' relates to deferment in the delivery of either consideration, such as: bay almu'ajjal, al-murabahah, bay' salam, bay' al-istisna, or both, like the case of ijarah, to a specified point in the future. Thus, deferred transactions are part and parcel of exchange activities which has been permitted by Shari'ah in its general principles. "O you who believe when you deal with each other in transactions involving future obligations in a fixed period of time reduce them to writing. Let a scribe write down faithfully as between the parties ... If you are on a journey, and cannot find a scribe, a pledge possession may serve the purpose" (Qur'an, 2:282). The forms of exchange transactions share same features which determine their main characteristics of being a part of sale contract. In short, the sale takes place in the case in which two things mutually transferred either on spot basis or with delay (Nur, n/a).

Conclusion

To sum up, the paper at hand tried to provide introductory information about the theory of exchange in area of economics. The author tried to provide the meaning of value from classical economists and philosophers' perspective vs. Islamic economists. Aristotle view is mainly related to ethics and labor power; while Marx's relate to Politics and ethics. Author also tried to provide view of contemporary Islamic philosopher's view in this paper. Al-Ghazali stated that economic activity must be based on the goal of happiness in the hereafter. His view on money was that money is the medium of exchange, and it was created to facilitate the exchange in the economic activities. Moreover, he stated that exchange of goods or services will not be effective if society relies only on barter system. Possession of money is not beneficial unless it is used as a means of exchange of goods and services. For him, money is also a measure.

In addition, paper stated features of exchange economy and its crucial role on creating additional economic value to the stage that one can reconsider economics as a science of exchange.

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